DOW THEORY LETTERS INC.

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THE MARKET: In the last Letter, I presented a "big picture" review regarding where I thought we were within the framework of this primary bear market. In my opinion, we are well into the second psychological phase of the bear market, and this, historically, is always the most deceptive and confusing phase to follow.

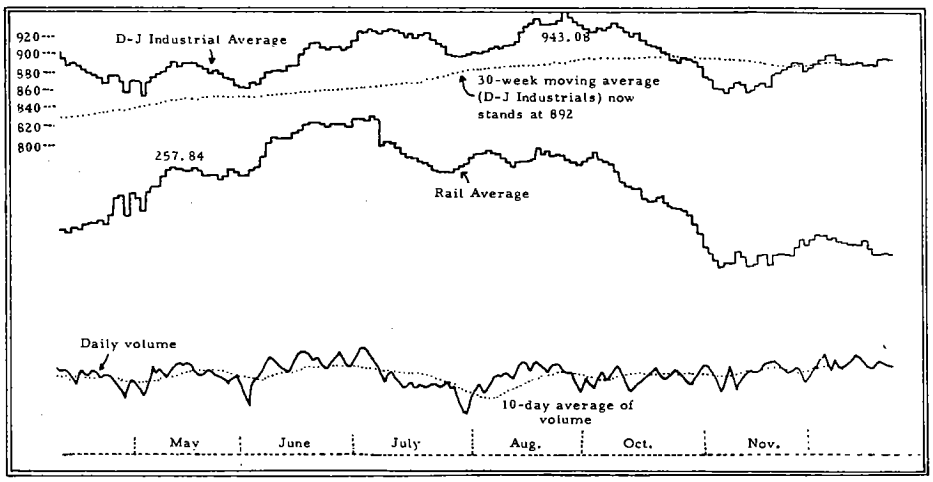
The 1966-67 rally, which started at the 1966 Industrial low of 744.32, divided the first phase from the second phase. That rally lasted a surprising 10 months, or until August 4, 1967, at which time the Rail Average topped out. As far as the Industrial Average alone was concerned, the rally lasted eleven months or until September 25, 1967, at which time the senior Average touched a recovery peak of 943.08. The whole rally was characterized by a speculative intensity probably only matched three or four times during the past 50 years. My colleague George Lindsay in his latest report calls this ".....the greatest speculative spree in history." I will not argue the point.

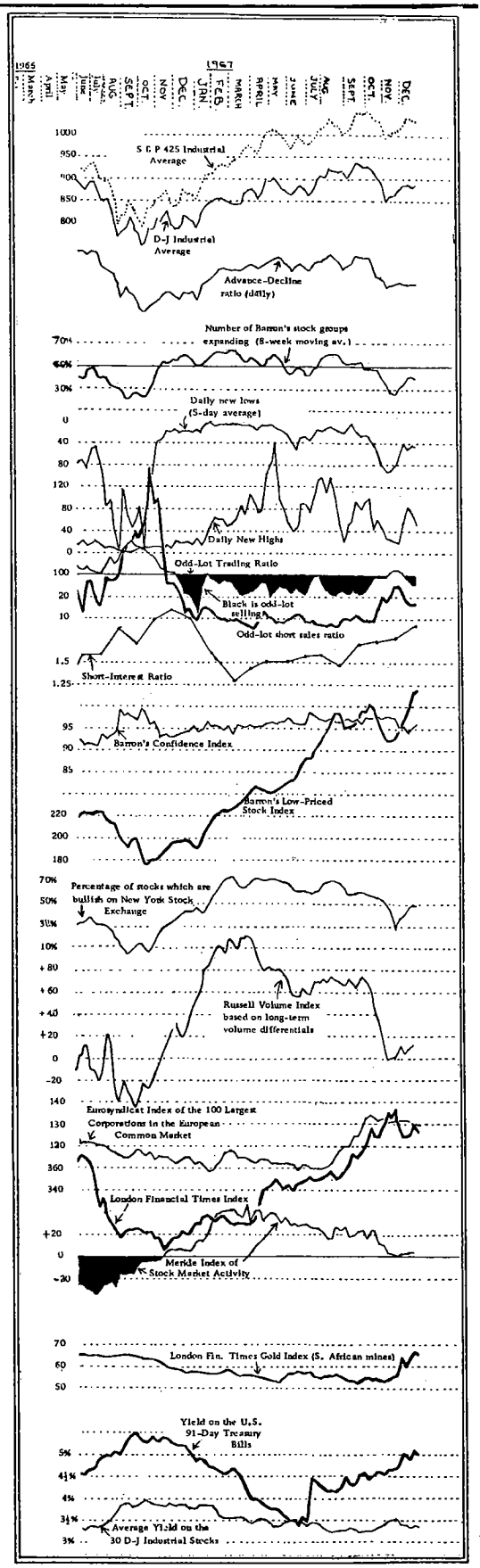
Nevertheless, during the rise the Industrial Average never did better its bull market (1966) high of 995.15, and thus the entire upward movement falls within the definition of a highly deceptive correction in a primary bear market. On the rally the Rails did better their 1966 high by a few points, thereby setting up a major non-confirmation, a non-confirmation which I feel lends a bearish appearance to the entire price structure (see chart, page 2).

I want to get this point across. Somewhere during the second phase of a primary bear market we can expect stocks to go down (they often crash) in response to a single or a series of shocking news events and developments. I believe we are heading for this general area now.

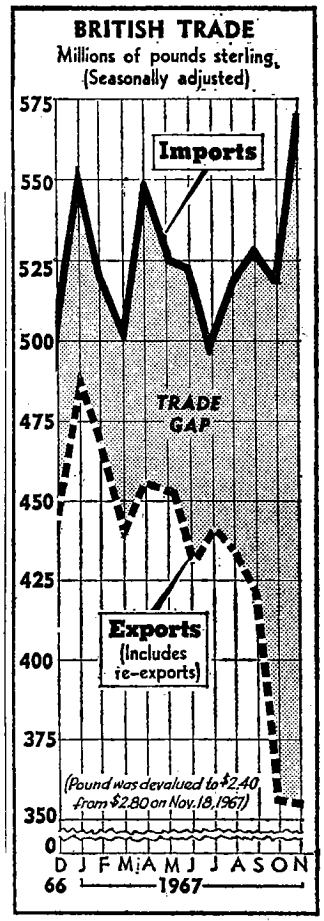
The first shock was Britain's 14.3% devaluation of the pound, an event which followed repeated denials and a resignation of Chancellor of the Exchequer Callaghan. The Federal Reserve Board promptly raised the U.S. discount rate to 4.5%, and a string of 25 nations came through the protective devaluation of their own currencies. A massive gold rush followed, with exchanges in Paris, Zurich and London exchanging record amounts of gold.

On the week ending December 13, the U.S. lost a record $475 million dollars worth of gold. As the Weekly Bond Buyer put it, this loss was almost triple




S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily new lows (5-day average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fin. Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

the amount of gold obtained during the entire historic Klondike gold rush (at which time $170 million in gold was mined). During the current period of massive gold losses, the newly devalued British pound has sagged precipitously until as of this writing all pound futures (see chart in last Letter) have broken below par or $2.40. Last week repeated support was needed for the new pound. In the opinion of Alden Wells (one of my favorite monetary experts)..."We believe the present $2.40 rate for the pound is unsupportable." With the pound still falling and with a shocking November trade balance (the worst in British history—see chart), I would expect another pound devaluation within a matter of months.



The New York Times Dec. 14, 1967

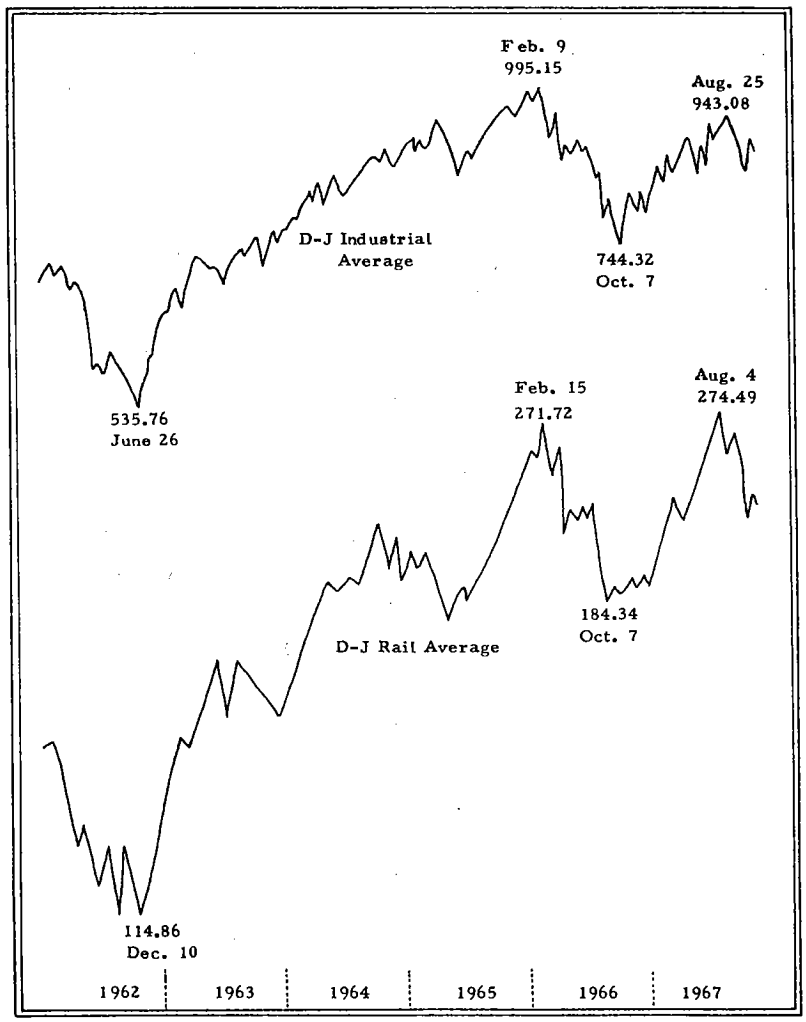
In terms of dollars, British trade gap widened to $367.5-million from $299-million.

A second pound devaluation would immediately throw enormous pressures on all other Free World currencies with prompt devaluation of probably 25% to 30% on the part of all the devaluation hold-out nations. At present, the Japanese, Italian, Canadian and Australian currencies are particularly shaky, and it would not surprise me to see devaluations here even before another British devaluation.

In the event of a second British devaluation, the dollar would be thrown into an untenable position, and devaluation would be forced upon the U.S. This possibility is undoubtedly one of the reasons behind the frantic gold buying of recent weeks, as investors all over the Free World (our Government calls them "speculators") seek to protect themselves against a potential collapse in the value of the dollar (in terms of gold).

Many believe that the U.S. market would rally (as did the London market) in the event of a dollar devaluation on the theory that speculators would then buy stocks in their rush to get out of dollars. I do not believe this. I believe (as was the case in London) that the U.S. market has been discounting the probability of dollar devaluation during this rise, and that an actual devaluation would send the market spinning sharply to lower levels.

It is well to note that last week the Federal Reserve Ratio dropped to 28.3%, dangerously close to the 25% legal limit for gold backing of U.S. currency. Thus, a bill eliminating all gold behind U.S. currency is a must for early 1968. In the event of continued gold losses, the U.S. may embargo gold, and this would mean that the Free World's leading gold price "fixer" had withdrawn from the market. In this case, gold would go free on the open market on a supply-demand basis, and this would amount to devaluation. A free market in gold would cause chaotic conditions in world currencies, but who knows—the U.S. Treasury has executed idiotic moves before.



Now I want to issue a real warning to subscribers, and I hope they take this seriously. In the past, monumental monetary disturbances such as the one we are now living through have been followed by collapsing stock markets and collapsing economies. I believe that the year 1968 will witness such events, and that this will throw us into the midst of the "crash and collapse" period of the second phase. The "holding period" of the second phase has already lasted too long and been marked by far too much speculation and manipulation (the latter on the part of our Government). Thus, I would expect the ultimate downward movement to be that much worse. As a rule, the longer and more drastic the counter-primary trend action in the

market and the economy, the worse the ultimate effect when the primary forces finally take hold. I expect the bear forces to really take hold during 1968.

It may be that the sensitive and highly leveraged (with debt) railroads are leading the market down while telling a story of trouble ahead for 1968. Referring to the long-term logarithmic chart (page 2), note that the Rails rallied from a 1966 low of 184.34 to a late-1967 high of 274.49. The halfway level of the Rail rally is 229.41. As of this writing, Rails have given back almost half their 1966-67 gains (though few analysts seem to realize this).

The fundamental story on the Rails is clear enough. Class 1 rail freight carloadings are down (first 9 months of 1967 against 1966) a full 5%. Operating revenues are down 5%. Labor costs are up 3% and rising rapidly. Rails are extremely sensitive to coming economic events. A potential steel strike next summer could hurt Rail traffic, tight money could hurt construction which in turn would hurt rail loadings, higher costs in general will hurt rail earnings, and already rails are cutting back on orders for new equipment. In all, I simply want to emphasize the importance of the Rail Average as a sensitive barometer of coming events. More often than not, the Rail Average is the first to "sense" troubles ahead; it may be doing that now.

Turning to the composite page 1 chart, it is notable that the advance-decline line has been lagging during the rally. Thus, the bulk of issues on the N.Y.S.E. have not been behaving well during the rise. New highs have also been lagging, and on December 18 new lows outnumbered new highs for the first time since August 7. Odd lots have turned to the normal year end selling, thus they are not a particularly significant indicator at present. Barron's Low Price Stock Index has risen to a 1967 high of 235, even while the leading averages are lagging. Thus the most significant upside action is again centered in the most speculative elements.

The Russell Volume Index is fluctuating around the 10-12 area, and I feel that it would take more upside action here to render a bullish verdict from this Index. The Merkle Index is still in the 5 area, having refused to go below zero and thereby rendering a bearish signal. The Index of South African gold mines has now formed a long base and broken out on the upside. At 67.2, it is at its highest level in two years. Last week the yield on the bellwether 91-day U.S. Treasury bills jumped at auction to 5.12%, and this was the highest yield since November, 1966. Note the steady climb in the bill yields since the summer low. These over-5% yields bode ill for all short-term money rates. When they go up, commercial paper, bankers' acceptances, financing terms, all money rates move in conjunction.

NOTES & QUOTES: "I have always thought," wrote Bernard Baruch, "that if, in the lamentable era of the 'New Economics,' culminating in 1929, even in the very presence of dizzily spiralling prices, we had all continuously repeated, 'two and two still make four,' much of the evil would have been averted."

It is too bad that our politicians and international central bankers could not review Baruch's prophetic words. Last week, for instance, one of the great absurdities of modern monetary history hit the newspapers. The report was that the U.S. and six other members of the Gold Pool had secretly decided to "have their cake and eat it too." The Pool members are to deposit large amounts of gold with the Pool, but this gold is not to show up as a loss in their respective gold reserves. In return they would receive "bank book" claims on the pool's assets. According to the New York Times, "The practice would allow countries to count the pooled gold as part of their own stock so that statistically their reserves would look no smaller." The article went on, "The purpose of the plan is to demonstrate to gold speculators that an almost infinite amount of resources are arrayed against them. The members of the pool have more than $26 billion in gold among them."

This pathetic "plan" is supposed to scare those who seek to protect themselves against the inflationary policies of the U.S. Government. The plan is also supposed to make two and two equal eight or ten. In other words, gold (which our New Economists scorn) is increasingly supposed to count for more and more in terms of assets.

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In his January report Alden Wells talks of politicians and statesmen who don't "understand" gold. This is it in a nutshell, for it takes a fundamental understanding of gold in order to grasp what is happening today. Reserve Board Chairman in a recent shocking show of ignorance talked about the "barbarous metal." He shows further ignorance when he talks about defending the $35 gold price down to the last bar of gold. For an insight into the fundamental meaning of gold, I would like subscribers to read the following carefully (from "The Role of Gold" by Prof. Arthur Kemp): "Governments and monarchs, from ancient times to the present, have frequently done their utmost to destroy gold's acceptability by laws, by rules and edicts, by taxes, by confiscation, by indoctrination and by ridicule. Yet an individual today could travel almost anywhere in the world with only a sufficient number of gold coins, stamped by some monarch long dead, whose legions are destroyed, whose kingdom is mythical, whose palace is dust. Such gold coins could be exchanged, even in these days of gross and net national product, for food, shelter and clothing in the private sector of the world economy if not in that of the public"

 Britain turned down an order for up to $500 million in arms for S. Africa. Since S. Africa wants these arms badly, she will probably now turn to France. This would give DeGaulle a number of possibilities. For instance, suppose DeGaulle insisted upon S. Africa selling a certain amount of its gold to the Paris market? I find it difficult to believe that DeGaulle will not make use of S. Africa's needs in the deal which I feel is coming up. It is worth watching.

DISCUSSION: One of my most knowledgeable investment advisor friends believes we are going into a giant money "crunch" during 1968. He believes that interest rates will skyrocket— thereby presenting the greatest bargains ever seen in bonds. However, he believes that in the face of these bargains, money will be almost unobtainable. Therefore, he is advising his clients to take options on money. He now advises going to the bank and borrowing say $100,000 for one year at current interest rates (say 7%) with an option to continue the loan for a second year. The proceeds of the $100,000 loan are then placed in 91-day Treasury bills with the interest from the bills used to pay off the loan. If the loan costs $7,000 (at 7%) to carry, and the bills into which the proceeds of the loan is placed yield $5,000 (at 5%) the cost of carrying the whole loan is only $2,000.

Following this policy, if the credit crunch comes the loan owner will have funds with which he will be able to buy bonds at fantastic bargain rates. When the crunch is over the bonds can be traded out at probably considerably higher prices. Thus, the owner of the $100,000 loan would be able to have important buying power at a relatively fixed rate (cost about $2,000) during a monetary crisis. The whole procedure provides one with a chance of large potential gains in the bond market (if the crunch arrives) with a very limited risk or cost.

I feel that there is much merit in this "hedge-speculation" type procedure. Actually, the only factor which I feel could negate the whole possibility of a 1968 credit crunch would be an ending of the Vietnam war. No one knows how far LBJ might go in election year 1968 towards ending the war, and I must admit that recent LBJ statements on the war have sounded very conciliatory. There is no doubt that LBJ would love to get out of the war well before 1968 election time. But of course, North Vietnam knows this well, and they will use such knowledge to their own ends.

How would an ending of the Vietnam war affect the gold shares? Since the war's end would help out balance-of-payments, this aspect of it would be favorable. However, the war's end would also probably affect business adversely, and we could easily have a massive slump following an ending of the war. A slump would be fought with inflationary policies, and one of the policies which our Government would turn to would be a massive outpouring of money. There would also be pressure to inflate in all directions, and this would mean pressure to inflate the world's reserves via a doubling or a tripling of the gold price.

I am indebted to Mr. Donald Macurda of La Mesa, California for the following information. Mr. Macurda (a former top analyst with a leading N.Y.C. bank) notes that the world trade figures are now contracting seriously. For instance, 1965 world exports were $165 billions, 1966 exports were $181 billions (up 9% from '65), but the 1967 figures are beginning to look ominous. The second quarter of 1967 (compared with 1966) shows a 1.7% gain (annualized), the third quarter shows a 1% gain, and early guesses for the fourth quarter show an actual contraction. Thus, the implications are that world trade is now beginning to contract after decades of expansion. If world trade contracts, there will be tremendous pressure to stimulate world trade via a rise in gold reserves or a rise in the price of gold. I feel that this slowing in world trade is going to be one of the most important issues during 1968. As yet, few people are aware of it (a slowing of world trade also implies that international price competition will become vicious).

THE DOW: The accompanying chart (from Traders Research, 1431 Pearl St., Alton, Ill. 62003) shows the current formation of the Dow in terms of weekly high, low and closing prices. So far the pattern shapes up as a potential "head-and-shoulders" formation with the main support level (dashed line) in the 850 area.

It will be most important over coming weeks to see whether the Dow can eliminate the head-and-shoulders potential (by rising to new recovery highs) or whether the pattern throughout most of 1967 is indeed a massive distributive formation.

Head-and-shoulder tops often (and mysteriously) maintain a symmetry, and if this pattern is to remain symmetrical we might still receive a rally to the 905-910 area, which is approximately the level of the left shoulder or rally to the May, 1967 peak (marked X on the chart).